

**Internal Revenue Service
Director, Exempt Organizations
Rulings and Agreements**

**Department of the Treasury
P.O. Box 2508 – EP/EO
Cincinnati, OH 45201**

Date: NOV 13 2002

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

Employer Identification Number:

[REDACTED]

Person to Contact – I.D. Number:

[REDACTED]

Contact Telephone Numbers:

[REDACTED]
[REDACTED]

Phone

FAX

Dear Sir or Madam:

We have considered your application for recognition of exemption from Federal income tax under the provisions of section 501(c)(3) of the Internal Revenue Code of 1986 and its applicable Income Tax Regulations. Based on the available information, we have determined that you do not qualify for the reasons set forth on Enclosure I.

Consideration was given to whether you qualify for exemption under other subsections of section 501(c) of the Code. However, we have concluded that you do not qualify under another subsection.

As your organization has not established exemption from Federal income tax, it will be necessary for you to file an annual income tax return on Form 1041 if you are a Trust, or Form 1120 if you are a corporation or an unincorporated association. Contributions to you are not deductible under section 170 of the Code.

If you are in agreement with our proposed denial, please sign and return one copy of the enclosed Form 6018, Consent to Proposed Adverse Action.

You have the right to protest this proposed determination if you believe it is incorrect. To protest, you should submit a written appeal giving the facts, law and other information to support your position as explained in the enclosed Publication 892, "Exempt Organizations Appeal Procedures for Unagreed Issues." The appeal must be submitted within 30 days from the date of this letter and must be signed by one of your principal officers. You may request a hearing with a member of the office of the Regional Director of Appeals when you file your appeal. If a hearing is requested, you will be contacted to arrange a date for it. The hearing may be held at the Regional Office or, if you request, at any mutually convenient District Office. If you are to be represented by someone who is not one of your principal officers, he or she must file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements as set forth in Section 601.502 of the Statement of Procedural Rules. See Treasury Department Circular No. 230.

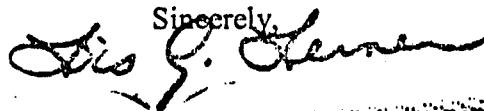
[REDACTED]

If you do not protest this proposed determination in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Internal Revenue Code provides, in part, that:

A declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within the time specified, this will become our final determination. In that event, appropriate State officials will be notified of this action in accordance with the provisions of section 6104(c) of the Code.

Sincerely,



Lois G. Lerner
Director, Exempt Organizations
Rulings and Agreements

Enclosures: 3

ISSUE #1

Whether [REDACTED] satisfies the legal requirements for exemption under Section 501(c)(3) of the Internal Revenue Code.

ISSUE #2

Whether [REDACTED] should be granted a Declaratory Judgment under Section 7478 of the Internal Revenue Code.

FACTS

The applicant is [REDACTED] (hereinafter referred to as "[REDACTED]") which was formed in [REDACTED] through [REDACTED]. [REDACTED] operated as a for-profit entity from [REDACTED] through [REDACTED]. [REDACTED] provided Articles of Incorporation indicating its for-profit status but it is not clear who signed the articles or whether an appropriate official of the [REDACTED] approved the articles. In Article Three, the purpose of the for-profit is "the promotion, aid, and development of commercial business and industry, to buy and sell real estate, to borrow and lend money; to build and construct buildings; and to engage in any lawful act or activity for which corporations may be organized under the [REDACTED]". These articles were amended on [REDACTED].

On [REDACTED], the Service received Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code from [REDACTED]. In Part II, Activities and Operational Information, Question 1 provides that the "purpose of the organization is to promote the economic growth of [REDACTED]". In response to Question 2 of this same part, the applicant responded that its sources of financial support would be currently held assets, public contributions, and sale of stock. In Part III, Technical Requirements, Question 10 [REDACTED] indicated that it is requesting a definitive ruling. Review of Part IV, Financial Data, shows that for the periods [REDACTED] it had total revenues of \$ [REDACTED] and total expenses of \$ [REDACTED].

[REDACTED] submitted Amended Articles of Incorporation with its Form 1023. These articles are signed and dated by nine officers and are notarized by one officer. The articles contain the language concerning exempt purpose, inurement and dissolution required for exempt status under section 501(c)(3) of the Internal Revenue Code. However, there is no indication that an appropriate official of [REDACTED] approved these articles. The articles provide in Article IV that, "the corporation shall have authority to issue capital stock pursuant to the provisions of Article Four of the previous Articles of Incorporation for said [REDACTED]".

[REDACTED] also submitted a printed brochure titled, "[REDACTED]". A review of this brochure discloses that donors who "invest in [REDACTED] future will be granted stock in [REDACTED] [REDACTED] (the cost of one share is \$ [REDACTED]). Prospective donors are further informed that, "the money will be placed in an interest-bearing CD and will not be utilized unless/until a majority of the Board of Directors vote to authorize the use of these funds for economic development purposes." The brochure contains a Frequently Asked Questions section which states that if a donor does not like the way the money is being spent, "as a stockholder, you will be invited to an annual shareholders meeting in which nominations and elections are held for the Board of Directors. Stock in [REDACTED] can be sold to another party." Another portion of this section responds to the question "What happens if you don't achieve your goal of accumulating

██████████ in principal?" by stating, "the Board of Directors will make a decision, based upon the amount received, if it is in the best interest of the shareholders to either continue with Investing in ██████████ or refund your money."

After an initial review of the application, the Service determined that additional information was needed in order to determine whether to grant exemption from Federal income tax. ██████████ was informed that the Service must have enough information to show that it meets all legal requirements because such information was not included in the application. In this same letter, ██████████ was provided the opportunity to submit conforming articles of incorporation and describe how it planned to operate exclusively for one or more of the purposes described in section 501(c)(3) of the IRC. The Service requested that ██████████ submit the additional information by ██████████.

The additional information was not received timely, therefore on ██████████ the case was placed in a temporary closed status. On ██████████, the Service received the additional information from ██████████. A review of this information disclosed that an appropriate official of ██████████ still had not approved the articles of incorporation. In addition, ██████████ stated that "we are not looking to support any charitable class(es) directly, but as noted in the assistance policy will be looking to the impact on low-to-moderate persons in our community as a determining factor for providing assistance to applicants." Included with this information was an ██████████ which outlined the goals, processes, and procedures used to determine whether funding assistance for endeavors proposed to ██████████ will be provided. Also submitted were Bylaws that describe ██████████ policy with respect to meetings of stockholders, capital stock, board of directors, officers, and dividends.

A review of the Bylaws indicates that non-shareholders may not attend meetings, call meetings, or vote for directors and officers. The capital stock provisions provide that the authorized capital stock is \$██████████ which is divided into ██████████ shares (██████████ with a \$██████████ par value and the private property of the stockholders of ██████████ which shall not be liable for the debts, obligations, or liabilities of ██████████ and which shall be non-assessable. While the board of directors does include representatives from various backgrounds, the provisions of the Bylaws provide that "directors must be stockholders." The provisions with respect to the dividends provide, in part, that the board of directors may declare and pay dividends upon the shares of capital stock of the corporation.

After a complete review of the additional information and research on economic development organization, the agent determined that ██████████ had not met the legal requirements for exempt status under section 501(c)(3) of the IRC, particularly with respect to the organizational test, the proscription against private benefit, and inurement. Therefore, on ██████████ a second letter was mailed to ██████████ requesting more information.

On ██████████, more information was received from ██████████. In its response ██████████ stated that, "all members of the board have always been required to own, or represent an entity which owns, at least one share of stock in the corporation as a pre-requisite to board membership, with voting rights." (See Question #8) ██████████ also stated that, if contributors are not satisfied with the activities or direction they can request return of their pledge" and that "the general plan is for any contributor to be issued stock in ██████████ in relation to the amount of such donation." (See Question #9)

In addition to responses to questions, ██████████ submitted a written statement to support the ██████████ depressed nature. This statement provides that, according to the year ██████████ census ██████████% of the total housing units in the ██████████ were vacant. This is in comparison to the year ██████████

census that almost [REDACTED] % of the households recorded incomes that were less than median household income, which was [REDACTED] \$1. In this statement [REDACTED] also stated that according to a wage survey submitted to the [REDACTED] [REDACTED] % of the community classified as low-to-moderate income. This is in comparison to a study conducted in [REDACTED] in which [REDACTED] % of the area classified as low-to-moderate income.

After a complete review of this information and research, the agent determined that [REDACTED] still had not met the legal requirements for exempt status under section 501(c)(3) of the IRC. The agent determined that [REDACTED] request for exemption status should be denied. Therefore, on [REDACTED], a letter was prepared and mailed along with Pub. 892 to [REDACTED] informing it that we plan to deny it request for exemption, along with our basis for denial, and its appeal rights. In this letter, [REDACTED] was provided another opportunity to demonstrate that it does meet the requirements for exemption under section 501(c)(3).

On [REDACTED], the Service received a response from [REDACTED] regarding the denial of its request for exemption under section 501(c)(3) of the IRC. In this letter [REDACTED] stated that, it has mailed the articles of incorporation to the Secretary of State's office for filing. That if we review the last few years' tax returns for [REDACTED] we will find that it has not made any money through its activities. [REDACTED] also stated that it made loans to a new start up business that expects to create sixteen new jobs, of which, some will be filled by low-to-moderate income persons. [REDACTED]'s main problem (or primary position) with the planned denial is that "there are several organization's in our area of [REDACTED], specifically within a fifty (50) mile radius of the [REDACTED], that have organizations set up exactly like ours and doing exactly the same type of activity, that are established as 501(c)(3) organizations. We would like to know what makes those organizations qualify when we cannot?"

LAW

LAW
Internal Revenue Code Section 501(c)(3) of the Internal Revenue Code. Exemption from tax on corporations, certain trusts, etc.

- (a) Exemption from taxation. An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 501 and 503.
- (c) List of exempt organizations. The following organizations are referred to in subsection (a):
- (3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes ..., no part of the net earnings of which inures to the benefit of any private shareholder or individuals.

Section 1.501(c)(3)-1. Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

- (a) Organizational and operational tests. (1) Provides in part that, in order to be exempt as an organization described in section 501(c)(3), an organization must be one that is both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational or the operational test is not exempt.

(b) Organizational test. (1) In general an organization is organized exclusively for one or more exempt purposes only if its articles or organization (referred to in this section as its "articles") as defined in subparagraph (2) of this paragraph:

(a) Limit the purposes of such organization to one or more exempt purposes; and

(b) Do not expressly empower the organization to engage, otherwise than an insubstantial part of its activities, in activities that in themselves are not in furtherance of one or more exempt purposes. (2) Articles of organization. For purposes of this section, the term "articles of organization" or "articles" includes the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created.

(c) Operational test. (1) Primary activities. An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes specified in Section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. (2) Distribution of earnings. An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

(d) Exempt purposes. (1) In general. (I) An organization may be exempt as an organization described in section 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes:

- (a) Religious,
- (b) Charitable,
- (c) Scientific,
- (d) Testing for public safety,
- (e) Literary,
- (f) Educational, or
- (g) Prevention of cruelty to children or animals.

(2) Charitable defined. The term "charitable" is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the under privileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening the burdens of Government; and promotion of social welfare.

Internal Revenue Code Section 7478. Declaratory judgments relating to status of certain governmental obligations.

- (a) Creation of remedy. In a case of actual controversy involving -
- (1) a determination by the Secretary whether interest on prospective obligations will be excludable from gross income under section 103(a), or
 - (2) a failure by the Secretary to make a determination with respect to any matter referred to in (1), upon the filing of an appropriate pleading, the Tax Court may make a declaration whether interest

on such prospective obligations, will be excludable from gross income under section 103(a). Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

(b) Limitations.

- (1) Petitioner. A pleading may be filed under this section only by the prospective issuer.
- (2) Exhaustion of administrative remedies. The court shall not issue a declaratory judgment or decree under this section in any proceeding unless it determines that the petitioner has exhausted all available administrative remedies within the Internal Revenue Service. A petitioner shall be deemed to have exhausted its administrative remedies with respect to a failure of the Secretary to make a determination with respect to an issue of obligations at the expiration of 180 days after the date on which the request for such determination was made if the petitioner has taken, in a timely manner, all reasonable steps to secure such termination.

BASIS FOR DENIAL

request for exemption under section 501(c)(3) of the Internal Revenue Code should be denied for the following five reasons.

Firstly, [REDACTED] has failed to provide the Service with articles of incorporation that have been approved by an appropriate official of [REDACTED]. Treas. Reg. Section 1.501(c)(3)-1(a) and (b) require that articles (or similar instrument) be submitted, otherwise an organization is not exempt.

Secondly, [REDACTED] plans to issue stock in exchange for donations from donors, which entitles the person to one voting right for each share owned. In addition, all members of the board are required to own or represent an entity, which owns at least one share of stock in the corporation as a prerequisite to board membership. These individuals holding stock will then be issued dividends either out of net assets or net profits. [REDACTED] requires that in order to be a director one is "required" to own stock in the corporation. These planned stock transactions conflict with the prohibition on inurement contained in sections 1.501(c)(3)-1(c)(1) and (2) of the Treas. Regs.

Thirdly, [REDACTED] does not plan to "operate exclusively" for a charitable purpose. Economic development is not, in itself, a charitable purpose within the meaning of IRC Section 501(c)(3). Generally, exemption has been granted to economic development corporations only where the area served is demonstrably economically depressed, or the development efforts are targeted to a charitable class, such as unemployed or low-income minority individuals. See Treas. Reg. Section 1.501(c)(3)-1(d)(1)(iii)(2). The statistical data [REDACTED] relies on, as evidence that the [REDACTED] is depressed, does not support the area is demonstrably depressed. The application and all of the additional information received from [REDACTED] indicates that the primary benefactors of its services will be "low-to-moderate income" persons, rather than a charitable class. The written statement [REDACTED] prepared, as evidence that the [REDACTED] is depressed, supports this contention. The statistical data upon which [REDACTED] relied in preparing its written statement is more than ten years old, incomplete and reflects that in the year [REDACTED] only [REDACTED] % of the housing units in the [REDACTED] were vacant (rather than depressed). Revenue Ruling 74-587, 1974-2 C.B. 162 describes a non-profit organization that qualified for exemption by providing low cost loans to businesses in economically depressed areas. The terms of financing were reasonably related to the needs of the particular businesses and the organization disposed of an equity interest as soon as the particular business' success was reasonably assured. See also Revenue Ruling 77-111, 1977-1 C.B. 144 which describes an organization that benefited the private interests of

businessmen in increasing patronage rather than promoting business activity in economically deteriorated areas. Exemption was denied to this organization because it was not primarily charitable instead, its overall thrust was to promote business generally. Even though this organization increased business patronage, it did not limit its activities to members of a charitable class.

Fourthly, [REDACTED] plans to return contributions to donors who are not satisfied with the activities or direction of the organization. If this will be the case, the amounts paid to [REDACTED] will not be considered a "charitable contribution" as that term is defined in section 170(c) of the IRC. The persons should not be allowed a charitable deduction as provided in section 170(a) of the IRC because they would be making an investment in [REDACTED] rather than giving a contribution. [REDACTED]'s planned course of action, with respect to these contributions, would permit persons to take a charitable deduction on their tax return then request return of their payment which could be used in computing capital gains/losses.

Lastly, [REDACTED]'s method of operating would allow private interests to be served rather than public purposes. The Bylaws submitted by [REDACTED] provides that all board members are required to own stock; only stockholders may vote on directors; the number of votes each stockholder has is based on the shares owned; the board of directors will determine if it is in the best interest of the shareholders to either continue with investing in [REDACTED] future or to issue refunds; and that contributions will be placed in an interest bearing CD and will not be used unless/until a majority of the board of directors vote to authorize the use of funds for economic purposes. These planned activities and method of how the board of directors will operate are adverse to the provisions of IRC Section 501(c)(3).

HERINGTON'S POSITION

[REDACTED] main problem with the proposed denial is that there are several organizations in the same area of [REDACTED] that are set up exactly like [REDACTED], doing exactly the same thing, and are a 501(c)(3) organization. [REDACTED] would like to know, what makes those organizations qualify when they cannot?

GOVERNMENT'S POSITION ON ISSUE #1

[REDACTED] submitted an application requesting exemption from Federal Income Tax under Section 501(c)(3) of the Internal Revenue Code, therefore the burden is on [REDACTED] to demonstrate that it meets the legal requirements for exemption. In the absence of such a showing, exempt status should be denied pursuant to 501(c)(3) of the IRC and Treas. Regs.

[REDACTED] has failed to demonstrate that it is an organization organized and operated exclusively for one or more of the purposes described in section 501(c)(3) of the IRC and Treas. Regs. [REDACTED] should not be granted exemption where it has not provided conforming articles of incorporation; when it plans to issue stock for monies received from donors; where a requirement for membership on the board of directors is based on the requirement of stock ownership; and where there is a strong presumption that private interests will be served rather than public purposes. [REDACTED]'s main problem with the proposed denial is not a rational basis upon which to grant exemption. There is no information that supports its assertion, therefore exemption should be denied.

GOVERNMENT'S POSITION ON ISSUE #2

[REDACTED] should be denied a Declaratory Judgment under Section 7478 of the Internal Revenue Code because it failed to timely submit information needed to determine whether exemption under section

501(c)(3) of the IRC should be granted. [REDACTED] mailed its application to the Service on [REDACTED], [REDACTED] and the application was received on [REDACTED]. The Service requested additional information on [REDACTED] and [REDACTED] did not reply until [REDACTED]. Upon review of this information, [REDACTED] was informed that the information submitted was not sufficient and a second request was made on [REDACTED]. [REDACTED] did not respond to this request until [REDACTED]. After review of this information, an initial determination was made that [REDACTED] had not met the legal requirements for exempt status, therefore its request should be denied. On [REDACTED], the Service informed [REDACTED] that we planned to deny its request for exempt status along with the basis for this position. [REDACTED] submitted its position to the proposed denial but it did not submit conforming articles of incorporation or modify its activities to comply with the "operated exclusively" requirement for exempt status under Section 501(c)(3) of the Internal Revenue Code.

CONCLUSION

Accordingly, based on the application, required and supporting materials, Herington does not satisfy the organizational and operational tests, and therefore does not meet the requirements for tax exemption under section 501(c)(3) of the Code and must file federal income tax returns.